Office of Chief Counsel
Internal Revenue Service

memorandum

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date:

to: JEANNE WIERMAN
Technical Advisor, Construction Industry

from: JOHN W. DUNCAN
Associate Industry Counsel, Construction Industry

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subject: **Definition of "Home Construction Contracts"**

This memorandum responds to your request for assistance regarding this matter. This memorandum should not be cited as precedent.

ISSUE

Whether the contracts described below are home construction contracts as described in I.R.C. § 460(e)(6)(A).

CONCLUSION

The contracts described below are not home construction contracts.

FACTS

You have asked us to discuss whether, under the following scenarios, the contracts involved are home construction contracts. Ordinarily, § 460(a) requires that long-term contracts be accounted for under the percentage-of-completion method of accounting. If, however, a long-term contract is a home construction contract, then the taxpayer can account for such contract under the completed-contract method of accounting. I.R.C. § 460(e)(1)(A); Treas. Reg. §§ 1.460-4(a) and (d). The advantage of the completed-contract method is that it allows deferral of net income from a contract until completion of the contract, rather than spreading out recognition of net income over the life of the contract as the percentage-of-completion method requires.

The first scenario involves a real estate developer who buys large tracts of land, subdivides the property, and installs roads, sewers, electrical lines, etc. prior to any sales of lots.

The taxpayer then sells the lots to individuals and contractors, who will eventually build single-family homes. The taxpayer does not construct any homes itself. Each sales contract includes a paragraph in which the taxpayer promises to build a common improvement, such as a golf course or clubhouse, in the near future. An example of such paragraph is as follows:

> C. Seller is obligated to construct a golf course and clubhouse within the proposed community in which the lot is located. The construction of the golf course and club house is to be completed within 5 years of the date of closing.

The second scenario also involves a developer who subdivides property, and then sells the lots to individuals and contractors. Like the above scenario, the taxpayer does not construct any dwelling units itself. Unlike the scenario described above, the common improvements are not golf courses or clubhouses, but are infrastructure, such as roads and sewers.

DISCUSSION

I.R.C. § 460(a) generally requires the use of the percentage-of-completion method of accounting for long term contracts.

I.R.C. § 460(e)(1)(A) provides that the general rule requiring use of the percentage of completion method does not apply to "any home construction contract." This provision was added to the Code by § 5041(b)(1) of the Technical and Miscellaneous Revenue Act of 1988.

I.R.C. § 460(e)(4) defines "construction contract" as "any contract for the building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvements of, real property."

I.R.C. § 460(e)(6)(A) defines "home construction contract" as any construction contract if 80 percent or more of the estimated total contract costs are reasonably expected to be attributable to those activities involved in a construction contract with respect to 1) dwelling units contained in buildings containing four or fewer dwelling units, and 2) "improvements to real property directly related to such dwelling units and located on the site of such dwelling units." Like § 460(e)(1)(A), this provision was added to the Code by the Technical and Miscellaneous Revenue Act of 1988.

For purposes of I.R.C. § 460(e)(6)(A), dwelling unit is defined at I.R.C. § 168(e)(2)(A)(ii) as "a house or apartment used to provide living accommodations in a building or structure... ."

We initially want to point out that the regulations regarding home construction contracts are effective for contracts entered into on or after January 11, 2001. For this reason, we will discuss this issue in the context of pre- and post-January 11, 2001 contracts.

We also want to dispel up front the common-sense notion that a home construction contract must involve the construction of a home. As indicated above, a home construction contract is simply a construction contract with respect to a dwelling unit. As § 460(e)(4) indicates, a construction contract can be for any of the following activities: building, construction, reconstruction, rehabilitation of real property, or the installation of any integral component to, or improvements to, real property. Thus, "construction" of a home in the technical sense is not an absolute prerequisite for a contract to qualify as a home construction contract. For this reason, when we use the word "construction" in this memorandum, we are referring to all the activities listed in § 460(e)(4) which cause a contract to be a construction contract for purposes of § 460.

Still, § 460(e)(6)(A) sets forth certain absolute requirements for a contract to qualify as a home construction contract. As referenced above, it must first be a construction contract. In Foothill Ranch Company Partnership v. Commissioner, 110 T.C. 95 (1998), the Service conceded prior to trial that a contract for the sale of land which required the seller to provide infrastructure and common improvements, similar to the scenarios described above, was a construction contract. The parties therefore agreed that the taxpayer was entitled to use the percentage-of-completion method, rather than the accrual method. (There is no suggestion in this case that the taxpayer claimed that it was entitled to use the completed contract method). The Tax Court found that the Service's initial position denying percentage-of-completion treatment was not substantially justified, and awarded the petitioner attorney fees. Although not precedential, recent Field Service Advice (1997 FSA Lexis 371) further indicates Service position that contracts for sale of land, in which the seller is required to provide infrastructure and/or common improvements, are construction contracts. For contracts entered into on or after January 11, 2001, Treas. Reg. § 1.460-1(b)(2)(ii) imposes an additional de minimus requirement. This section provides that a contract is not a construction contract if it includes the provision of land by the taxpayer and

the estimated total allocable contract costs are less than 10 percent of the contract's total contract price. For example, if a taxpayer expects to receive $100,000.00 from a contract which includes the sale of land, then at least $10,000.00 of the taxpayer's costs under such contract must be allocable to its construction activities. Nonetheless, the above authorities demonstrate that a pre-January 11, 2001 contract involving the sale of land and the construction of infrastructure and common improvements is a construction contract, and that a post-January 10, 2001 contract is a construction contract if it meets the additional requirements of the regulations.

If a contract qualifies as a construction contract, then it is a home construction contract if 80 percent of the estimated total contract costs are attributable to construction of a dwelling unit and improvements to real property "directly related to such dwelling units and located on the site of such dwelling units." I.R.C. § 460(e)(6)(A). This statute states that for improvements to be part of the 80 percent computation, they must be "directly related to such dwelling units," i.e., those dwelling units to which the taxpayer is performing some type of § 460(e)(4) construction activity. If there are no construction activities related to dwelling units, then there are no improvements to real property related to "such dwelling units." In other words, improvements not related to dwelling units for which there is some type of § 460(e)(4) activity cannot be used to qualify a contract as a home construction contract, since such expenses are not related to "such dwelling units" attributable to § 460(e)(4) activities.

This view is supported by the new regulations and prior authority. For contracts entered into before January 11, 2001, Notice 89-15, 1989-1 C.B. 634, provides guidance on several issues under § 460 in a question-and-answer format. Q&A 43 discusses what is a home construction contract, stating consistently with the above discussion that it is a construction contract for which 80 percent or more of the estimated total contract costs are reasonably expected to be attributable to "the building, construction, reconstruction, or rehabilitation of (i) dwelling units ..., and (ii) improvements to real property directly related to such dwelling units and located at the site of such dwelling units." Q&A 44 clarifies that off-site work, such as for roads, sewers, and other common features, are attributable "to the dwelling units that the developer is constructing," and that the cost of such off-site work is "attributable to the construction of the house for purposes of the 80-percent test." The language chosen in these questions and answers clearly anticipates that the improvements will be related to some construction activity involving a dwelling. A common

theme in these Q&As is the developer's construction activities on dwelling units, and how the developer's right to include the cost of improvements in the 80-percent test depends on the developer's construction activities on dwelling units. Service position, as indicated in Notice 89-15, appears to be that improvements to property unrelated to construction activity on a dwelling unit are not included in the 80-percent computation of § 460(e)(6)(A). If property is improved absent construction of a dwelling unit, then the contract for such improvements is not a home construction contract, as none of the costs are attributable to § 460(e)(4) activities with respect to a dwelling unit or to improvements related to such dwelling units.

For contracts entered into on or after January 11, 2001, the recently promulgated regulations similarly indicate Service position that contracts of the type described above are not home construction contracts. Treas. Reg. § 1.460-3(a) defines long-term construction contracts in relevant part as involving the building, construction, reconstruction, or rehabilitation of real property, the installation of an integral component (such as elevators and central heating systems) to real property, or the improvement of real property. Real property as used in this section means land, buildings, and inherently permanent structures.

Treas. Reg. § 1.460-3(b)(2) defines home construction contract as a long-term construction contract for which 80 percent of the estimated contract costs are attributed to "dwelling units" and improvements to real property directly related to, and located at the site of, "the dwelling units." As with Notice 89-15, these regulations require that the cost of improvements included in the 80-percent computation be related to the construction of "dwelling units."

Indeed, the regulations are even more clear on this issue than Notice 89-15. Treas. Reg. § 1.460-3(b)(2)(iii), in discussing the treatment of common improvements, states that the taxpayer includes such costs "in the cost of the dwelling units" to the extent of their allocable share of such costs. This is a clear statement that some construction activity on a dwelling unit must occur in order for a contract to qualify as a home construction contract.

Furthermore, Treas. Reg. § 1.460-3(c) provides additional support for the proposition that a contract void of any home construction activity cannot be a home construction contract. This section distinguishes a residential construction contract from a home construction contract, with the distinction being the number of dwelling units per building. This section provides

that a residential construction contract is a home construction contract, "except that the building or buildings being constructed contain more than 4 dwelling units." This section is a clear statement that a residential construction contract, like its cousin the home construction contract, must involve "building or buildings being constructed." We again remind you that "construction" may mean, among other things, rehabilitation or reconstruction. Nonetheless, the above authorities consistently indicate that some sort of construction activity with respect to dwelling units is required in order for the related costs to be included in the 80-percent test.

In spite of the above, we understand that certain persons and/or firms are suggesting to taxpayers that the new regulations do not require any construction activity on dwelling units. They claim that the absence of a reference to "developer" in the new regulations after the use of that term in Q&A 44 of Notice 89-15 indicates Service intent that no construction on a dwelling unit is required in order for a contract to be a home construction contract. In light of the above discussion, we fail to see any merit in such position. The new regulations require some level of construction activity on dwelling units. The fact that Notice 89-15 referenced a "developer"'s need to construct dwelling units, while Treas. Reg. § 1.460-3(b) references a "taxpayer"'s need to construct dwelling units should make no difference in these scenarios. We are perplexed by the suggestion that the use of more general terminology in the regulation than in Notice 89-15 somehow made the class of people subject to such provisions more restrictive. The notice discussed at one point how "a developer" can use the completed contract method only in connection with construction of a house; the regulations discuss how "a taxpayer" can use the completed contract method in connection with its construction of a dwelling unit. Treas. Reg. §§ 1.460-3(b)(2) and (c). At the risk of stating the obvious, a developer as described in the notice is a taxpayer. The recently promulgated regulations's references to "taxpayer" rather than "developer" do not exclude any group, including developers, from the prerequisites for use of the completed-contract method of accounting.

We are also aware of one pre-January 11, 2001 contract, in which the taxpayer is arguing as follows: 1) a sub-contractor responsible for roads or other infrastructure related to a home construction contract may use the completed contract method; 2) in the taxpayer's situation, it, rather than a sub-contractor, is installing such infrastructure, and therefore 3) the taxpayer should be entitled to the same favorable treatment as would a subcontractor. The fallacy behind this argument should be obvious. While a subcontractor providing infrastructure related

to a home construction contract would in fact be entitled to use the completed contract method, a sub-contractor making identical improvements for a taxpayer who is selling the land rather than constructing houses would not, since there is no home construction activity. A taxpayer involved in the above scenarios would not be a party to a home construction contract, and therefore would not be entitled to use the completed contract method of accounting.

We nonetheless want to point out language in the legislative history of § 460(e)(6) that an aggressive taxpayer might claim contradicts our conclusion. H.R. Conf. Rep. No. 100-1104, at 118 (1988) says that a contract is a home construction contract if 80 percent or more of the estimated total costs to be incurred are reasonably expected to be attributable to the building, construction, reconstruction, or rehabilitation of, "or improvements to real property directly related to and located at the site of, dwelling units...." (emphasis added). Unlike § 460(e)(6), which discusses dwelling units and improvements "directly related to such units", a reading of the legislative history without reference to the statute might cause one to believe that the contract can be for dwelling units or improvements to real property, such as roadways. We believe that this should not be an issue. In interpreting statutory language, courts look first to whether the relevant statutory language itself is plain and unambiguous. See United States v. Ron Pair Enterprises, Inc., 489 U.S. 235, 241 (1989); Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842 (1984). If the statutory language is ambiguous, courts may consider legislative history. See Robinson v. Shell Oil Co., 519 U.S. 337, 340 (1997). In the present case, however, the statute appears clear, looking to the costs of dwelling units and "improvements...directly related to such dwelling units." We nonetheless want to apprize you of this seeming inconsistency.

You also asked whether the taxpayer can delay completion of the contract by delaying completion of a part of a common improvement, such as a private club, for several years. Because we have concluded that the scenarios described above do not involve home construction contracts, and that such contracts cannot therefore be accounted for under the completed contract method, this question is presently moot. We nonetheless want to direct you to Treas. Reg. § 1.460-1(c)(3)(i)for contracts entered into on or after January 11, 2001, which generally provides that a contract is completed upon the earlier of a) use of the subject matter of the contract by the customer for its intended purpose and the taxpayer's incurring at least 95 percent of the total allocable contract costs, or b) final completion and acceptance of the subject matter of the contract. In the case of contracts

accounted for under the completed contract method, the date a contract is completed is determined without regard to secondary items. Treas. Reg. § 1.460-1(c)(3)(ii). For contracts entered into before January 10, 2001, Treas. Reg. § 1.451-3(b)(2) set forth a "facts and circumstances" test, with the specific prohibition against delaying completion for the principal purpose of deferring income tax. As mentioned above, because the contracts described in your scenarios are not eligible for the completed-contract method, the question of when these contracts are completed need not be presently discussed in detail.

To summarize, neither of the contracts in the scenarios described above constitutes a home construction contract. In these scenarios, the contracts fail the 80-percent test of § 460(e)(6)(A) because none of the reasonably expected costs are attributable to construction of dwelling units or improvements directly related to such dwelling units.

Please be advised that we consider the statements of law expressed in this memorandum to be significant large case advice. We therefore request that you refrain from acting on this memorandum for ten (10) working days to allow National Office review. If you have any questions regarding the above, please contact the undersigned at (602) 207-8052.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

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